



Income Tax Update

News and developments for tax practitioners

A publication of the Income, Sales and Special Taxes Division

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Tax Commissioner

New adjustment added to Form ND-1 for nonresident military personnel

A new subtract adjustment is available to nonresident individuals serving in the U.S. armed forces. The new adjustment is found on line 13 of page 1 of the 2004 Form ND-1. A nonresident individual may enter on this line the compensation received for service

in the U.S. armed forces. Service in the U.S. armed forces means active duty in the U.S. Army, Air Force, Navy, Marine Corps, or Coast Guard, or service in the commissioned corps of the U.S. Public Health Service and National Oceanic and Atmospheric Administration.

The adjustment was added to comply with the Servicemembers Civil Relief Act of 2003 (Public Law No. 108-189), which prohibits a state from using a nonresident individual's federal active duty military pay to increase the tax on other income of the nonresident or the nonresident's spouse that is taxable by the state. This federal legislation replaced what was formerly known as the Soldiers' and Sailors' Civil Relief Act of 1940.

Note: No change was made to Form ND-2 (Optional Method) because the tax calculation method used on it conforms to the Servicemembers Civil Relief Act.

Filing an amended return for 2003. The 2003 Form ND-1 had been finalized and printed before the Servicemembers Civil Relief Act of 2003 was passed and signed

into law. Therefore, no adjustment was provided for on the 2003 return. A notice was placed on the Office of State Tax Commissioner's Web site to inform affected nonresident military personnel about the Act, including instructions on how to claim the adjustment for 2003. If a Form ND-1 was filed for 2003 by a nonresident military person, or by the spouse of a nonresident military person, and the adjustment for the military pay of the nonresident military person was not claimed, an amended 2003 Form ND-1 may be filed to claim the adjustment.

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To file an amended return, obtain a 2003 Form ND-1 and complete it just like the original return with the following modifications:

1. Write "Servicemembers Civil Relief Act" at the top of page 1 of Form ND-1.
2. Enter the nonresident individual's active duty military compensation on line 5 of Form ND-1, and write "nonresident military pay" on the dashed line to the left of the amount. (Note: Line 5 is normally reserved for interest from U.S. obligations. If the individual also has interest from U.S. obligations, enter the total of the two adjustments on line 5.)
3. If Schedule SF is required to be completed, the amount entered on line 5 of Form ND-1 must also be entered on Schedule SF, Part 2, line 5 in the column for the nonresident military spouse. 

"Enter the nonresident individual's active duty military compensation on line 5 of Form ND-1, and write 'nonresident military pay' on the dashed line to the left of the amount."

Important changes apply to corporations for 2004 tax year

Effective for taxable years beginning after December 31, 2003, the following apply for corporation income tax purposes:

- The federal income tax is not deductible in calculating North Dakota taxable income. Schedule FTD, therefore, no longer applies and has been eliminated as a supplement to Form 40.
- The federal alternative minimum tax not allowed as part of the federal income tax deduction in a previous year may not be recaptured and is not deductible in calculating North Dakota taxable income. Schedule AMT-R, therefore, no longer applies and has been eliminated as a supplement to Form 40.
- The tax rates are as follows:

If North Dakota

taxable income is:

The tax is:

Over	But not over	
\$ 0	\$ 3,000.....	2.60% of North Dakota taxable income
3,000	8,000.....	\$ 78.00 + 4.10% of the amount over \$ 3,000
8,000	20,000.....	283.00 + 5.60% of the amount over 8,000
20,000	30,000.....	955.00 + 6.40% of the amount over 20,000
30,000	1,595.00 + 7.00% of the amount over 30,000

- If an eligible corporation elects to use the water's edge method to apportion its income, in addition to the tax calculated using the regular tax rates (shown above), the corporation must pay a surtax of 3.5% of North Dakota taxable income.

In addition to the above changes brought about by the 2003 North Dakota Legislature, please note the following items when preparing the 2004 Form 40:


- **New check-off added authorizing discussion of return with preparer**

A new box has been added in the lower right-hand portion of Form 40 (next to the signature area) that the corporation may check to authorize the Office of State Tax Commissioner to talk directly with the preparer of the return should any questions arise during the processing of the return. This includes requesting missing information, providing information on the status of payments or a refund, and responding to error notices. Checking the box does not authorize the preparer to receive a refund check, bind the corporation in any way, or otherwise represent the corporation before the Office of State Tax Commissioner. The authorization automatically ends on the due date (excluding extensions) for filing the corporation income tax return for the immediately following tax year—for example, if the box is checked on the 2004 Form 40 filed on a calendar year basis, the authorization automatically ends on April 15, 2006, the due date of the 2005 Form 40.

- **Use the officially-prescribed forms and schedules**


The complete, accurate, and efficient processing of the Form 40 requires that the official versions of the form, including its supplementary schedules, be completed in their entirety and as prescribed. Schedules created by taxpayers, tax preparers, or software vendors should not be used in lieu of completing all applicable lines on the official forms. Separately created schedules may only be used to support individual entries on the official forms. If separately created schedules are provided in lieu of completing the officially-prescribed forms and schedules, the tax return will be regarded as incomplete and will be returned to the taxpayer.

- **Consolidated return filers must complete Schedule CR**

If a consolidated North Dakota corporation income tax return is filed, Schedule CR must be completed. On line 1 of Form 40, filing method box b1 (100% North Dakota Consolidated Return), b2 (Apportioning Corporation Consolidated Return), or c1 (Water's Edge Method Consolidated Return) will be checked if the return is being filed on a consolidated basis for North Dakota corporation income tax purposes. 

New worksheets added to Form ND-1 for investment tax credits


Two new worksheets have been added to the 2004 Form ND-1 instructions to assist taxpayers with calculating their allowable tax credit for investing in a qualified agricultural commodity processing facility or a qualified seed capital business. The worksheets are located on pages 11 and 12, respectively, of the Form ND-1 instruction booklet. To complete the worksheet, taxpayers must have available their copies of the investment reporting form given to them by the qualified businesses at the time of their investment.

Note: Due to the limited use of the Form ND-2 (Optional Method), the worksheets were not included in the Form ND-2 instruction booklet. 

"Two new worksheets have been added to the 2004 Form ND-1 instructions to assist taxpayers with calculating their allowable tax credit for investing in a qualified agricultural commodity processing facility or a qualified seed capital business."

"A tax credit is allowed to full-year residents and part-year residents if they pay income tax to another state on income that is also taxed by North Dakota."

\$2.5 million ceiling on seed capital tax credits reached in 2004

A tax credit is allowed to individuals, estates, and trusts for making an investment in a qualified seed capital business. Current law provides that no more than \$2.5 million in tax credits may be allowed for investments made in all tax years. This ceiling on total allowable tax credits was reached in early 2004. Because the total tax credits calculated on investments made in all tax years exceeded \$2.5 million, the law requires the \$2.5 million of allowable tax credits to be allocated to taxpayers based on the chronological order of their investments. Consequently, certain taxpayers will lose part or all of their tax credit because their investments were made on or after the date the \$2.5 million tax credit ceiling was reached. The Office of State Tax Commissioner will notify these taxpayers by letter to inform them of their allowable tax credit for the 2004 tax year. 

Schedule ND-1CR and Schedule 4 improved for part-year residents

A tax credit is allowed to full-year residents and part-year residents if they pay income tax to another state on income that is also taxed by North Dakota. In the case of part-year residents, though, the tax credit is allowed only if the income taxed by both North Dakota and the other state was earned or received during the part of the year they were residents of North Dakota. The 2004 Schedule ND-1CR and 2004 Schedule 4 were revised to clarify and simplify their application for part-year residents. In addition, examples were added to the instructions to illustrate how certain lines should be completed.

Line 1 of the schedule was expanded into three lines to help part-year residents sort out what income is eligible for the tax credit. A part-year resident determines the income eligible for the tax credit in the following two steps:


Step 1: Calculate amount of federal adjusted gross income sourced in the other state

The first step is to identify the amount of the taxpayer's federal adjusted gross income that has its source in the other state. This requires that each item of income, gain, loss, and adjustment to income included in federal adjusted gross income be reviewed to determine the portion that is taxable or deductible under the other state's tax law. Any adjustment to federal adjusted gross income that is required or allowed under the other state's tax law—such as for a personal exemption, standard deduction or itemized deduction, or other state statutory adjustment—must be disregarded in making this determination.

Step 2: Calculate amount of other state's source income earned or received while a North Dakota resident


The second step is to determine how much of the amount calculated in Step 1 was earned or received while a legal resident of North Dakota.

Part-year resident example. For the 2004 tax year, a taxpayer was a Montana resident from January 1 through June 30, and a North Dakota resident from July 1 through December 31. While a Montana resident, she received wages of \$10,000 for work performed in Montana. After she moved to North Dakota, she received an additional \$18,000 of wages for work performed in North Dakota. She also owns land in Montana from which she received net rental income of \$1,000 per month (for a total of \$12,000 for the year). Following are the amounts to be reported on her 2004 Schedule ND-1CR:

Description	Amount	Enter on Schedule ND-1CR
Federal adjusted gross income (\$10,000 + \$18,000 + \$12,000)	\$40,000	Line 1a
Amount of federal adjusted gross income having a		
source in Montana	\$22,000	Line 1b
<ul style="list-style-type: none"> • \$10,000—Wages earned in Montana • \$12,000—Net rental income from land in Montana 		
Montana source income earned or received while		
North Dakota resident	\$6,000	Line 1c
(Net rental income of \$1,000 per month for 6 months) 		

Correction made to National Guard and Reserve member pay exclusion

A correction has been made to the military pay exclusion allowed to National Guard and U.S. armed forces reserve members called to federal active duty under Title 10 of the United States Code. The instructions to line 12 of the 2004 Form ND-1 and line 22, Schedule 2, of the 2004 Form ND-2 were changed to provide that the exclusion is allowed for federal active duty service regardless of whether the service is performed inside or outside North Dakota. The instructions to the 2003 returns incorrectly stated that the exclusion is allowed for federal active duty service performed outside North Dakota—see “Filing an amended return for 2003” below. In addition to the correction, a new instruction was added requiring National Guard and Reserve members to attach a copy of their military orders supporting their call-up to federal active duty under Title 10 of the United States Code.


Filing an amended return for 2003. If a North Dakota return was filed for 2003 but the exclusion was not claimed because of the error in the instructions for that year, an amended 2003 North Dakota return may be filed to claim the exclusion. Attach a copy of the military orders showing the call-up to federal active duty under Title 10 of the United States Code. 

Filing a return for a deceased taxpayer

If a final federal individual income tax return is required to be filed for a decedent for the year of death, a final North Dakota individual income tax return must also be filed. If a personal representative has been appointed, the personal representative is responsible for filing the decedent’s final North Dakota return for the year of death, even if there is a surviving spouse. In general, the information from the final federal return is used to complete the final North Dakota return. Similarly, the final North Dakota return is to be signed in the same manner as required for federal income tax purposes.

If there is a personal representative and no surviving spouse, the personal representative must include with the decedent’s return a copy of the court document supporting the appointment as personal representative.

If there is a surviving spouse and the final North Dakota return will be filed on a joint basis, a refund will be mailed in both spouses’ names. If the surviving spouse experiences any problem with depositing or cashing the check, contact the Individual Income Tax Section, Office of State Tax Commissioner for assistance.

If there is no surviving spouse and no personal representative has been appointed for the decedent, contact the Individual Income Tax Section, Office of State Tax Commissioner for instructions on how to obtain a refund. 

“The instructions to line 12 of the 2004 Form ND-1 and line 22, Schedule 2, of the 2004 Form ND-2 were changed to provide that the exclusion is allowed for federal active duty service regardless of whether the service is performed inside or outside North Dakota.”


Correction made to 2003 Schedule ND-1FA

There is an error in the 2003 Schedule ND-1FA, Calculation of tax under 3-year averaging method for elected farm income. On line 5, the second sentence reads as follows:

If you used Schedule ND-1FA to calculate your tax for 2002, enter amount from 2002 Schedule ND-1FA, line 5.

This is incorrect. This sentence should read as follows:

If you used Schedule ND-1FA to calculate your tax for 2002, enter amount from 2002 Schedule ND-1FA, line 11.

This error affects the calculation of the tax only if a Schedule ND-1FA was used to calculate the tax for the 2002 tax year. If this error affected the calculation of the tax on the 2003 Form ND-1, an amended return must be filed for 2003 to correct the error. 

Interim legislative committees propose bills for 2005 session

A number of bill drafts affecting North Dakota income tax law have been proposed for introduction into the 2005 North Dakota legislative session by the Interim Taxation Committee and the Interim Economic Development Committee. A complete list of bill drafts as well as copies of the minutes of the Committees' meetings are available on the North Dakota Legislative Branch's Web site.

- ▶ To see the text of any of the bill drafts, go to the North Dakota Legislative Branch's Web site at www.state.nd.us/lr/ and click on **Interim Information >> - 2003-2004 >> Committee Bill Drafts**.
- ▶ To see the minutes of the committee meetings in which these bill drafts were introduced and discussed, go to the North Dakota Legislative Branch's Web site at www.state.nd.us/lr/ and click on **Interim Information >> - 2003-2004 >> Committee Minutes and Agendas**.

Interim Taxation Committee Bill Drafts

Following are selected bill drafts proposed by the Interim Taxation Committee.

- **Retroactive recognition of Servicemembers Civil Relief Act** (Bill draft no. 50072.0100). This bill draft proposes to retroactively recognize certain provisions of the Servicemembers Civil Relief Act of 2003 (Pub. L. 108-189). Section 511 of this federal legislation applies to U.S. armed forces personnel stationed in a state that is not their state of legal residence. It prohibits the state from including the military pay of a nonresident servicemember in the calculation of the state's income tax if its inclusion causes an increase in the tax owed on other income sourced in the state. The proposed bill draft allows a claim for refund of an overpayment attributable to Section 511 of the Act to be filed for tax years 2001 and 2002. If the regular time period for filing a claim for refund for 2001 expires before August 1, 2005, the time period is extended to April 15, 2006.

- **Inclusion of tax haven corporation in water's edge group** (Bill draft no. 50075.0100). This bill draft proposes to include in a water's edge group a corporation that is incorporated in a tax haven and has a unitary relationship with the other members in the group. Also, income shifted to a tax haven, to the extent taxable, will be considered income subject to apportionment.
- **Income tax withholding from distributions of passthrough entities** (Bill draft no. 50076.0200). This bill draft proposes to require a partnership, S corporation, or other passthrough entity to withhold income tax at the highest individual income tax rate on the distributive share of income of a nonresident individual member of the entity. Withholding would not be required in the case of any nonresident individual member who has an annual distributive share of income of less than \$1,000 or who elects to be included in a composite return filed by the passthrough entity. A publicly traded partnership (as defined under I.R.C. § 7704(b) which is treated as a partnership for federal tax purposes and agrees to file an annual information return on which it identifies each unitholder having North Dakota source income over \$500 is not subject to the withholding requirement.
- **Addback of income from non-North Dakota securities on Form ND-1** (Bill draft no. 50077.0100). This bill draft proposes to create a new adjustment on Form ND-1, the main income tax return for individuals, to include interest and dividends from foreign securities and from securities of states and their political subdivisions exempt from federal income tax in North Dakota taxable income. This does not include interest income from obligations of North Dakota or any of its political subdivisions.

Interim Economic Development Committee Bill Drafts

Following are selected bill drafts proposed by the Interim Economic Development Committee.


- **Revision of seed capital investment tax credit** (Bill draft no. 50145.0200). This bill draft proposes the following changes to the seed capital investment tax credit, effective for tax years beginning after December 31, 2004: (1) Expand eligibility for the credit to include corporations and all passthrough entities; (2) Remove restriction on eligibility for individuals who operate business on a full-time professional basis; (3) Remove \$5,000 minimum investment criteria; (4) Limit amount of investment eligible for credit to \$2.5 million per qualified business; and, (5) Limit total credits allowed for all investments made in a calendar year to \$2 million.
- **Repeal of venture capital and SBIC investment tax credits** (Bill draft no. 50167.0100). This bill draft proposes to repeal the North Dakota venture capital corporation investment tax credit (under N.D.C.C. ch. 10-30.1) and the North Dakota small business investment company investment tax credit (under N.D.C.C. ch. 10-30.2).
- **Expansion of new or expanding business income exemption** (Bill draft no. 50196.0100). This bill draft proposes to increase the exemption period from five to ten years.

"This bill draft proposes to require a partnership, S corporation, or other passthrough entity to withhold income tax at the highest individual income tax rate on the distributive share of income of a nonresident individual member of the entity."

Stay up-to-date on the 2005 legislative session

For comprehensive information on the upcoming 2005 North Dakota Legislative Assembly, go to the North Dakota Legislative Branch's Web site at www.state.nd.us/lr/ and click on **59th (2005)** under **Legislative Assembly**. There, information can be found on the state's legislators, legislative committees and hearings, the text and status of legislative bills, and audio and video of daily legislative floor action. 

Forms 58 and 60 preparation is not affected by certain separately reported property dispositions


In 2003 the Internal Revenue Service revised the instructions to the Form 1065 and Form 1120S to provide that a partnership or S corporation should not use Form 4797 to report dispositions of property for which an I.R.C. § 179 expense deduction was previously passed through to its owners. Instead, information about these dispositions must now be separately reported to the owners in the supplemental information section of Schedule K-1. This change in reporting means that gains or losses on these dispositions will not be included in the amounts reported on Schedule K of either Form 1065 or Form 1120S. No adjustment needs to be made to Form 58 or Form 60 to account for the gains or losses on these dispositions. The reporting of these gains or losses to North Dakota will be deemed satisfied through the attachment of a complete copy of the federal return (which includes the Schedule K-1) to the Form 58 or Form 60. 

"Please check to see if your tax software includes a feature called a two-dimensional (2-D) barcode."

Reminder: If you prepare a paper return by computer for a client, use software's 2-D barcode feature


Whether it's because some of your clients prefer not to file their returns via electronic means, or because you do not offer electronic filing to your clients, you are preparing paper returns for some or all of your clients. And it's a good bet that you're using a computer with special tax software to prepare and print them. Please check to see if your tax software includes a feature called a two-dimensional (2-D) barcode. If it does, we ask that you turn that feature on. And so you don't become confused, a 2-D barcode looks much different than the type of barcode you see on products in stores. Most obvious is its size, which is much bigger in height and width. If the 2-D barcode feature is on, you'll easily notice the barcode on the printed return.

The 2-D barcode feature collects all of the information from the return and places it in a two-dimensional barcode that is printed in the upper right-hand portion of page 1 of the return. Upon receipt of a return with the barcode, our office simply scans the barcode to retrieve all of the information contained in the return. Even though a paper return is filed, the 2-D barcode feature allows our office to electronically retrieve and process the information on the return, and reap nearly all of the same benefits afforded by electronic filing—streamlined data entry, fewer errors, reduced cost to taxpayers, and fast refunds.

If you aren't sure if your tax software has the 2-D barcode feature, or if you don't know how to turn the feature on, contact Chuck Picard, Information Management Officer, North Dakota Office of State Tax Commissioner—phone: 701-328-3129; e-mail: cpicard@state.nd.us. 


Reminder: A corporation may not carry back an NOL incurred in 2003 or later

Have you filed an amended return for a corporate client to carry back a 2003 North Dakota net operating loss, only to have the claim for refund denied? In our July 2003 edition of this newsletter we informed tax preparers that the 2003 North Dakota Legislature repealed the provisions allowing a carryback of a North Dakota net operating loss for a corporation. North Dakota net operating losses incurred by corporations in taxable years beginning after December 31, 2002, may not be carried back to a previous tax year. Note: A capital loss may still be carried back.

Federal net operating loss carryback. Please keep in mind that if a corporation files a claim for refund attributable to the carryback of a *federal* net operating loss, the corporation must file an amended North Dakota return to reduce the amount of the federal income tax deduction for the tax year to which the federal net operating loss was carried back to. 

"North Dakota net operating losses incurred by corporations in taxable years beginning after December 31, 2002, may not be carried back to a previous tax year."

E-filing numbers continue their upward climb

Electronic filing of individual income tax returns continues to grow. As of November 4, 2004, the Office of State Tax Commissioner received 129,509 electronically filed North Dakota individual income tax returns for the 2003 tax year—a 25 percent increase over the number filed for 2002. This means that about 40 percent of all individual filers now use e-file. 

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Income tax withholding	701-328-3125	<i>withhold@state.nd.us</i>
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